DEPARTMENT OF STATE REVENUE

02-20120612.LOF

Letter of Findings: 02-20120612
Corporate Income Tax
For the Tax Year 2009

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ISSUE

I. Adjusted Gross Income Tax–"Factoring Fees."

Authority: IC § 6-3-1-3.5; IC § 6-3-2-2; IC § 6-8.1-5-1; IC § 6-8.1-3-12; 45 IAC 3.1-1-8; 45 IAC 3.1-1-62; Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 63 S.Ct. 1132 (1943); Park 100 Dev. Co. v. Indiana Dep't of State Revenue, 429 N.E.2d 220 (Ind. 1981); Sweetland v. Franchise Tax Board, 13 Cal. Rptr. 432 (Cal. Ct. App. 1961); Enterprise Leasing Co. of Chicago v. Indiana Dept. of State Revenue, 779 N.E.2d 1284 (Ind. Tax Ct. 2002); Letter of Findings 02-20030423 (May 25, 2005); Letter of Findings 02-20060511 (November 15, 2007); Letter of Findings 02-20090945 (June 11, 2010); Letter of Findings 02-20090805 (July 1, 2010); Letter of Findings 02-20100494 (January 4, 2011).

Taxpayer protests the Department of Revenue's decision that a portion of Taxpayer's factoring fees paid to a related entity should be disallowed.

STATEMENT OF FACTS

Taxpayer is a wholesale distributor operating in Indiana. As a result of an audit investigation, the Indiana Department of Revenue ("Department") issued a proposed assessment for additional adjusted gross income tax and interest for the 2009 tax year. In the investigation, the Department disallowed a portion of the claimed factoring fees in order to fairly represent Taxpayer's Indiana income. Taxpayer protested. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as necessary.

I. Adjusted Gross Income Tax–"Factoring Fees."

DISCUSSION

After conducting an audit of Taxpayer's tax returns as filed, which included a review of Taxpayer's books and records, the Department made adjustments to Taxpayer's reported Indiana adjusted gross income. Upon reviewing the documented facts and circumstances, the Department determined that a portion of Taxpayer's claimed factoring fees artificially distorted Taxpayer's Indiana income. Therefore, the Department, in order to fairly reflect Taxpayer's Indiana income, under authority of IC § 6-3-2-2(l) and (m) made an audit adjustment to disallow a portion of the factoring fees.

Taxpayer paid factoring fees to a related entity, which was not included in Taxpayer's Indiana income tax return filing. Taxpayer subcontracted the collection of its accounts receivable to the related entity by "factoring" its accounts receivables to the related entity (hereafter, "RFE"). The Department disallowed over $57 million of the factoring fees that Taxpayer paid to "RFE." This amount that was added back to Taxpayer's federal taxable income represented the portion of the factoring fees that Taxpayer paid to "RFE" that exceeded the "RFE's" expenses in providing the "factoring services."

The Department's audit report (on pages 6-8) stated the following to support the adjustment:

> During the stated period the taxpayer group, as an economic entity, does not achieve any business or operational advantage that it did not have before the Taxpayer started factoring its receivables. The in-house factoring does not provide the access to lower financing cost, the most common reason for having factoring operations. The same departments such as accounting (for account receivable), credit and collection, customer service, treasury, etc. which existed before the receivable factoring was put in place still exist. [However,] now these functions have become part of the ["RFE's"] operations, a non-filer for Indiana.
>
> It appears that for the period February 1 to December 31, 2009, the major benefit achieved by such factoring operations is minimizing their state income tax exposure. This creates a distortion of the adjusted gross income as reported without a corresponding benefit to the whole organization (such as liquidity and cheaper interest rates).
>
> The receivables factoring function of ["RFE"] has a very important aspect in the overall corporate organization . . . [because] it reported more income than all the other entities in the consolidated group, including the Taxpayer, the most dominant entity. . . . [financial charts omitted].
>
> It is also noted that a portion of the receivable factoring expense paid by the Taxpayer comes back to the Taxpayer in the form of dividends and loans by ["RFE"]. In 2007, ["RFE"] paid the Taxpayer [$100,XXX,XXX] in dividends. Investable funds owned by ["RFE"] are loaned back to affiliates –the bulk of which goes to the Taxpayer. Inter-company interest earned by ["RFE"] on those loans [to Taxpayer] is [$11,XXX,XXX for the 2009 tax year].

In support of the position to make the adjustment to fairly reflect income, the audit report cited to IC §

6-3-2-2(l)(4) and IC § 6-3-2-2(m). IC § 6-3-2-2(l)-(m) provide as follows:

(l) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(1) separate accounting;

(2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;

(3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or

(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

(Emphasis added).

Accordingly, IC § 6-3-2-2 addresses issues of determining "adjusted gross income derived from sources within Indiana." Specifically, sections (l) and (m) allow the Department or a taxpayer to employ an alternate method, if necessary, to fairly reflect and report the taxpayer's income derived from sources within Indiana. IC § 6-3-2-2(m) provides the Department with authority to distribute, apportion, or allocate income derived from Indiana sources among commonly owned organizations in order to fairly reflect Indiana income. Additionally, IC § 6-3-2-2(l)(4) clearly contemplates the use of any other method intended to effectuate equitable allocation and apportionment of a taxpayer's income to fairly reflect a taxpayer's Indiana income.

Taxpayer asserts that the Department may not rely on IC § 6-3-2-2(l) and (m) to adjust Taxpayer's taxable income by disallowing or adding back a portion of the factoring fees. Taxpayer states that it believes that IC § 6-3-2-2(l) "only permits the Department to adjust a taxpayer's apportionment formula and not its taxable income." Taxpayer also believes that "the regulations provide that special cases of allocation arise in only limited and usual circumstances when the standard apportionment produces incongruous results. 45 IAC 3.1-1-62." Finally, Taxpayer believes that the Department cannot rely on IC § 6-3-2-2(m) because "the Indiana statutes, regulations nor case law set forth a standard by which the Department may exercise its authority under IC § 6-3-2-2(m)" and therefore it cannot be used by the Department.

As noted in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

It is well-settled that corporations are free to adopt the corporate form and to engage in activities they deem appropriate. The Supreme Court has stated that the "doctrine of corporate entity" serves a useful purpose and that "so long as [the] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Moline Properties, Inc. v. Comm'r, 319 U.S. 436, 438-439, 63 S.Ct. 1132, 1134 (1943). However, the Court continued, "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." Id. at 439. The state courts have been consistent in applying this "business purpose" doctrine, holding that tax avoidance in and of itself is not a valid "business purpose." See Park 100 Dev. Co. v. Indiana Dep't of State Revenue, 429 N.E.2d 220 (Ind. 1981); Sweetland v. Franchise Tax Board, 13 Cal. Rptr. 432 (Cal. Ct. App. 1961).

The Internal Revenue Code requires taxpayers to report and pay federal income tax when their gross income exceeds a certain amount. For state income tax purposes, the presumption is that taxpayers properly and correctly file their federal income tax returns. Thus, to efficiently and effectively compute what is considered the taxpayer's Indiana income tax, the Indiana statute refers to the Internal Revenue Code. However, IC § 6-3-1-3.5(b) simply provides that federal taxable income is the starting point for determining Taxpayer's Indiana adjusted gross income. IC § 6-3-1-3.5(b) states that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code) adjusted as follows . . . ." The Department's Administrative Rules repeat this basic principle at 45 IAC 3.1-1-8 stating that "'Adjusted Gross Income' with respect to corporate taxpayers is 'taxable income' as defined in Internal Revenue Code – section 63) with three adjustments . . . ." Thus, a taxpayer's federal "adjusted gross income" is merely the starting point to calculate what would be the taxpayer's Indiana income tax; IC § 6-3-1-3.5(b) thereafter requires that the individual taxpayer make certain mandatory additions and subtractions to that starting point.

IC § 6-3-2-2 addresses determining a taxpayer's "adjusted gross income derived from sources within Indiana." While Taxpayer is correct that IC § 6-3-2-2(l) does discuss adjustments to a taxpayer's apportionment, IC § 6-3-2-2(l) also contains provisions discussing other adjustments to arrive at a taxpayer's Indiana income. IC § 6-3-2-2(l) and (m) explain that if the standard formulas for apportionment and allocation do not fairly reflect a taxpayer's Indiana income then the Department may depart from the standard formulas and use alternate methods to fairly reflect and report the taxpayer's income derived from sources within Indiana. Specifically, IC § 6-3-2-2(m) provides a mandate for the Department to make adjustments and provides that the Department " shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect." The plain language of IC § 6-3-2-2(l)(4) provides that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect to all or any part of the taxpayer's business activity . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." Id. (Emphasis added). Additionally, IC § 6-3-2-2(l)(1) allows for a "separate accounting" which also counters Taxpayer's argument that the statute provisions only allow for an adjustment to the a taxpayer's apportionment and not adjustments to a taxpayer's federal taxable income. Thus, if Taxpayer's contentions were correct, these provisions of IC § 6-3-2-2(l) and (m) would be rendered a nullity. Enterprise Leasing Co. of Chicago v. Indiana Dept. of State Revenue, 779 N.E.2d 1284, 1294 (Ind. Tax Ct. 2002). ("The Court will avoid an interpretation that renders any part of the statute meaningless or superfluous.")

Moreover, 45 IAC 3.1-1-62 states:

Special Formulas for Division of Income. All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37–45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results. (Emphasis added).

Taxpayer suggests that "[45 IAC 3.1-1-62] provide[s] that special cases of allocation arise in only limited and usual circumstances when the standard apportionment produces incongruous results." However, Taxpayer interprets the regulation too narrowly. The regulation states that "[the Department] anticipate[s] that these situations will arise only in limited and usual circumstances (which ordinarily will be unique and non-recurring)." Id. The regulation's language of anticipation is not the language of limitation that Taxpayer suggests. The regulation's language of anticipation does not preclude the Department from applying its remedial powers, but instead provides guidance that the Department generally expects not to use its remedial powers. However, as the regulation states, when the standard formula "works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states" the Department will use an alternate method. Id.

Furthermore, IC § 6-8.1-5-1(b) explains that if the Department reasonably believes that a person has not reported the proper amount of tax due, the Department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department. Finally, IC § 6-8.1-3-12 explains that the Department may investigate any matters relating to a listed tax. Read together, these statutes and the regulation allow the Department to review a taxpayer's reporting methods and to make adjustments to reflect that taxpayer's Indiana income as fairly and accurately as possible.

Accordingly, when the Department finds that a taxpayer's income as reported does not fairly reflect the taxpayer's Indiana income, the Department may use "any other methods"–including the method used in this case–to fairly reflect the taxpayer's income. The statutes and regulations contemplate the Department to approach the situation–to make adjustments to fairly and accurately reflect a taxpayer's income–on a case by case basis in light of the facts and particular information available to the Department for that particular taxpayer. See IC § 6-3-2-2(m) (providing a broad mandate that the Department " shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect.") See also IC § 6-3-2-2(l) (offering a few options but also providing broadly that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect to all or any part of the taxpayer's business activity . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.")

In that vein, the Department has routinely found and offered guidance for circumstances justifying the disallowance or add back of claimed expenses in its published letters of findings, for example: when a taxpayer makes intercompany payments and takes expenses for these payments but is unable to explain the "nature and substance of the underlying agreement" and transactions, Letter of Findings 02-20030423 (May 25, 2005), 28 Ind. Reg. 3379; when the deduction of the royalty expenses and interest expenses are part of a continual circular flow of money back and forth between the related entities–with the result of shifting taxable income to out-of-state subsidiaries that would then return non-taxable income to the Indiana entities–calling into question the necessity for the transactions and resulting in an "unfair reflection of the income earned from Indiana sources," Letter of

Findings 02-20090945 (June 11, 2010), 20110323 Ind. Reg. 045110114NRA; when the payment of expenses constitutes an "abusive tax scheme," Letter of Findings 02-20060511 (November 15, 2007), 20080130 Ind. Reg. 045080019NRA; when the payment of royalties results in an intercompany circular flow of money which served no "commercial business purpose," Letter of Findings 02-20100494 (January 4, 2011), 20110323 Ind. Reg. 045110119NRA.

Alternatively, Taxpayer argues that if the Department may generally rely on IC § 6-3-2-2(l) and (m), the Department may not rely on IC § 6-3-2-2(l) and (m) for Taxpayer's situation. Taxpayer maintains that the income as originally reported by Taxpayer fairly reflects its activities within Indiana. Taxpayer maintains that "RFE" is an operating company which actively pursues the collection of the factored accounts receivables for which "RFE" has charged an arm's-length rate based upon a transfer pricing study. Taxpayer states that "the transfer pricing study was prepared in accordance with Internal Revenue Code Section 482 and the regulations thereunder." Taxpayer states that the pricing study was prepared by an independent third party and that the factoring fees reported on the federal returns fell within the range of acceptable prices listed in the study. Therefore, Taxpayer believes that the factoring fees are valid as reported and the Department's adjustments to its Indiana income based upon these fees are unnecessary and incorrect.

However, a specific transaction's arm's-length status considered in isolation is not a factor that is relevant to the determination of whether or not the "substance" of the taxpayer's overall company structure, intercompany transactions, and consolidated group's deductions fairly reflect a taxpayer's consolidated group's Indiana adjusted gross income. Especially, when the particular transfer pricing study was performed to analyze a transaction's arm's-length status in relations to isolated federal tax consequences and was not performed in relation to the state tax consequences of the transactions. In fact, the transfer pricing study that Taxpayer provided states that it was not performed for state tax purposes and should not be used by the taxpayer as advice for state tax purposes. Specifically, the transfer pricing study presented by taxpayer (on page 3) provides that the advice provided was limited in scope as follows:

> Our Advice is limited only to whether Client's transfer pricing practices, with respect to the Covered Transactions in FY 2009 satisfy the requirements of Internal Revenue Code section 482.
>
> The tax advice set forth addresses specific US federal income tax issues. Client has not request us to consider, and **we have not considered**, any other US federal income tax issues; any non-income tax issues; or **any state, local or foreign income tax issues**. Accordingly, **we do not reach any conclusions regarding** any other US federal income tax; non-income tax; or **state, local, or foreign tax issues**. . . . We express no advice other than as stated herein, and neither this report nor any prior statements are intended to imply otherwise or to be advice on any other matters. (**Emphasis added**).

Moreover, the transfer pricing study, on page 5, also puts Taxpayer on notice to not use this report for any other issues, specifically other tax issues, and that the report was limited to Taxpayer's compliance with Internal Revenue Code section 482 for transactions governed under Illinois laws and regulations, as follows:

> This submission is limited to issues concerning compliance for the specified transactions with Treas. Reg. Section 482 governing transactions within a controlled group. **Additional issues may exist that could affect the US tax treatment of the transaction that is the subject of this report and our report does not consider or provide a conclusion with respect to any additional issues**. **With respect to any significant tax issues outside the limited scope of the submission, the submission is not intended** by [the report's authors] to be used by any person **for the purpose of advice or avoiding any penalties that may be imposed on any taxpayer**.
>
> In accordance with our agreement this report is **limited to issues concerning compliance for the specified transaction with the specific state laws and regulations of Illinois governing transactions within a controlled group**. Additional issues may exist that could affect the state and Federal tax treatment of the transaction that are the subject of this report, and the report does not consider or provide a conclusion with respect to any additional issues. **With respect to any significant tax issues outside the limited scope of this report, the report is not intended by** [the report's authors] to be used by an person **for the purpose of advice or avoiding any penalties that may be imposed on any taxpayer.** (**Emphasis added**).

Lastly, Taxpayer points to Letter of Findings 02-20090805 (July 1, 2010), 20100728 Ind. Reg. 045100448NRA, issued to an unrelated third party which also had reported expenses for factoring fees paid to its related factoring company. Taxpayer maintains that its protest should be sustained like the taxpayer in Letter of Findings 02-20090805 because the "business purpose and substance of ['Related Finance Entity'] are substantially similar to that of the factoring company" described in Letter of Findings 02-20090805. However, Taxpayer's situation is not factually similar to the situation of the taxpayer and its related financing company in Letter of Findings 02-20090805. Unlike the Department's audit report for the taxpayer in Letter of Findings 02-20090805 that did not present any evidence of a circular flow of funds between the taxpayer and its related factoring company, the Department's audit report for Taxpayer did present evidence of circular flows of funds between Taxpayer and "Related Finance Entity." As noted in Letter of Findings 02-20090805, the Department's audit report did not present evidence that the related factoring company had either loaned the factoring fees back to the taxpayer or had returned the factoring fees back to the taxpayer in the form of dividends. Conversely, the Department's audit report for Taxpayer clearly noted that "RFE" was loaning the factoring fees back to Taxpayer each year under investigation, had received over $11 million in interest payments from Taxpayer, and had paid approximately $100 million of dividends to Taxpayer in 2007.

During the hearing, Taxpayer was asked to provide documentation and information addressing the purportedly circular flows of funds between "Related Financing Entity" and Taxpayer. However, Taxpayer merely provided a statement that "Related Finance Entity" did not pay dividends to Taxpayer in 2009 and did not provide any information or documentation about the intercompany loans and interest. When one considers the "substance" of the overall company's structure and the intercompany transactions–where factoring fees are paid to an entity that returns monies back to Taxpayer in the form of tax free dividends and/or intercompany loans, the Department was legitimately concerned that Taxpayer exploited the company's structure and the intercompany transactions to shift a substantial portion of their Indiana source income outside the state, that Taxpayer's Indiana income did not match their claimed Indiana expenses, and that it was appropriate to take steps to assure that Taxpayer's taxable income fairly reflected the income attributable to Indiana sources.

Based upon the available information, in this particular case, the Department is not able to agree that Taxpayer has met their statutory burden under IC § 6-8.1-5-1(c) of demonstrating that the Department's decision disallowing a portion of the factoring expenses is incorrect.

FINDING

Taxpayer's protest is respectfully denied.

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